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Capacity Cuts Won't Immediately End Chinese Steelmakers' Woes

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HONG KONG (S&P Global Ratings) Nov. 7, 2016--China's steelmakers will continue to feel short-term pain despite the government's plan to speed up capacity elimination in the domestic steel market. That's according to a report, titled "Road To Recovery Remains Bumpy For China's Steelmakers," that S&P Global Ratings published today.

"Over the long term, Chinese steelmakers will benefit from the government's push for capacity reduction and consolidation in the local steel industry," said S&P Global Ratings credit analyst Ellen Li. "But their debt burden will remain a risk to creditworthiness. Additionally, currency depreciation and trading frictions could erode profitability."

This round of consolidation should materially improve the competitiveness and efficiency of Chinese steelmakers--albeit with a long lead time. The government has set a clear target for capacity reduction with a firm timeframe, which is being implemented under the "supply-side" reform process initiated at the end of 2015.

In our view, steelmakers' profitability will likely improve if price recovery persists. However, we do not expect the likely improvement in cash flows, which will be moderate, to significantly reduce companies' debt burden because it's very high.

The sector's average leverage as measured by the ratio of net debt to EBITDA has been above 5x since 2012. We expect leverage to remain high in the next 12

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months. We believe debt leverage will only gradually improve over the next two to three years when industry consolidation solidifies, improving steelmakers' pricing power and reducing their costs and capital spending.

"We believe the government's initiative on debt-equity swap will help deleveraging, but the scheme will be selective among steel companies with good competitive advantages to navigate the market conditions," said Ms. Li.

We anticipate that refinancing risk will remain another key risk for steel companies in China, and distressed debt restructuring could pass on the credit risks to the financial system.

We expect Chinese steelmakers' credit profile to improve only over next two to three years as the industry consolidates. Supply curtailment should gradually help to restore selling prices and cost optimization will improve margins, underpinning a recovery in profitability and deleveraging.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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